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SUBJECT: THE ECB STEPS IN AS GERMANY'S LARGEST BANK FEELS SUBPRIME STING

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¶1. (SBU) SUMMARY: On October 3 Deutsche Bank, Germany's largest commercial bank, announced it would write off 2.2 billion euros ($3.12 billion) in losses based in investments in U.S. mortgage-backed securities, ending several weeks of speculation about the bank's exposure to subprime debt. The financial world was surprised to learn that Deutsche Bank, with its reputation as a shrewd and conservative actor, was the most deeply invested in subprime vehicles of all of Germany's large commercial banks. Deutsche Bank's overall financial position remains healthy with third-quarter net profits expected at 8.4 billion euros ($12 billion). The announced write-offs have contributed to the crisis of confidence in the banking sector. Interbank lending, even among the major German banks, has ceased, with the European Central Bank plaYing a key intermediary role in providing liquidity to the market. END SUMMARY.

¶2. (U) In a series of meetings in Frankfurt on October 11-12, EMIN and Congen Econoff met with executives and senior officials at Commerzbank, Deutsche Bank, Morgan Stanley, the Bundesbank, and the European Central Bank (ECB). Discussions ranged from the recent troubles of German banks to the role played by the ECB during the ongoing subprime crisis.

DEUTSCHE BANK: FIREMAN OR ARSONIST?

¶3. (SBU) The declared insolvency and subsequent bail-outs of two small German state-backed banks, SachsenLB and IKB Deutsche Industriebank AG, in August prompted widespread speculation about the health of Germany's banking system and its exposure to subprime debt (see reftels). Media sources reported that these small German banks were driven by low returns on investments at home to invest heavily in U.S. mortgage-backed securities that seemingly promised the impossible: high returns and low risk. Germany's three largest commercial banks (Deutsche Bank AG, Commerzbank AG and Dresdner Bank AG) were believed to be better protected from the subprime plague due to their larger size, greater diversification and perceived long-standing aversion to high-risk investments.

¶4. (SBU) In a September 4 article in Handelsblatt, Deutsche Bank Chief Executive Officer Josef Ackermann weighed in to calm panic in the financial community, saying: "I am optimistic about the environment globally for financial institutions." Ackermann argued that, in the current crisis, the bad debt in the U.S. was shared more widely due to the dispersal of risk worldwide and therefore the

system was more stable. In a nod to the perceived need for banking consolidation in Germany, he said "Progress is a continuous process of creative destruction. The present subprime crisis and its consequences, harbors, like all crises, not only risks, but also opportunities." His statements as "Germany's top banker" buoyed markets in Frankfurt, and led to Deutsche Bank's shares rebounding 2.6% that day.

¶5. (SBU) Despite Ackermann's attempt to calm the panic, he came under fire for his apparent lack of sympathy for banks in trouble and Deutsche Bank's own role in selling high-risk products to small banks such as IKB. On the same day Ackermann's article came out, Heinrich Haasis, the President of the German Savings Bank Federation (DSGV), said of Deutsche Bank at a conference in Frankfurt, "You should not give advice on putting out fires when, in the past, you not only did not put the fire out, but also sold the wood for the fire and profited from it." Ackermann later rejected the criticism, rejoining that "of course we sold all sorts of products to IKB. That is our business. They made a lot of money for a long time."

DEUTSCHE BANK'S OWN FIRE

¶6. (SBU) Deutsche Bank's own exposure became apparent on September ¶20. In an address to German broadcaster ZDF, Ackermann admitted that the bank had "made mistakes during this crisis," and that third quarter profits would reflect those mistakes. Ackermann stated that 29 billion euros ($40.5 billion) yn credit agreements needed to be "reassessed" thanks to high risk investing in the United States housing market. He said that Deutsche Bank would most likely not hire 4,000 additional staff by the end of the year as originally planned. This preliminary statement caused Deutsche Bank shares to drop by 3% on the Frankfurt stock exchange. Seeking to calm any panic, Germany's Finance Minister, Peer Steinbruck, weighed in later in the day, reassuring markets that "Deutsche Bank stands on a solid

foundation."

¶7. (SBU) On September 24, a Reuters report claimed that Deutsche Bank was faring far worse than Ackermann had admitted. According to the report, Deutsche Bank's credit was actually worth between 4% and 6% less than face value, nearly twice as bad as Ackermann's predictions. On the same day, Commerzbank, Germany's second largest bank, reiterated its announced profit target for 2007 in order to diffuse rumors that it too was suffering from the subprime collapse. Several papers reported that Ackermann, who in November 2006 survived widespread public criticism for his role in the Mannesmann affair, would be forced to step down earlier than the planned end of his term in 2010. An executive at Deutsche Bank, told EMIN and Econoff that there was a misperception in the media that Ackermann either did not know about his bank's exposure when he made his remarks in early September or did not want to admit it, when in fact Ackermann had been consistent all along in his message, acknowledging that Deutsche Bank, too, had made mistakes.

¶8. (SBU) On October 3, Deutsche Bank announced that it would write off 1.5 billion euros ($2.1 billion) in residential mortgage-backed securities and structured credit products, as well as 700 million euros (nearly $1 billion) in leveraged loans. The announcement of the losses was offset by the news that other gains in asset sales and tax credits will lead to a third-quarter profit of 1.4 billion euros ($2 billion). The announcement helped bring clarity to the question of Deutsche Bank's exposure. Nevertheless, Deutsche Bank's shares are down 9% since the beginning of August. Deutsche Bank officials told us that the write-offs were not so much a result of the fact that the securities were all that risky, but rather of Deutsche Bank's inability to find a buyer during the current turbulence.

WEATHERING THE STORM

¶9. (SBU) A senior official at the European Central Bank, confirmed to EMIN and Econoff that "lending markets between banks are still functioning poorly in Europe due to the crisis of confidence."

Germany's other large commercial banks appear to have weathered the storm better than Deutsche Bank. The chief executive of Commerzbank, Klaus-Peter Mueller, said on September 20 that the bank would set aside a comparatively small 92 million Euros ($128 million) for possible losses from the subprime crisis, although it has been rumored that this sum may not be enough. Dresdner Bank set aside an equally small 70 Million Euros ($100 million). An executive at Commerzbank, confirmed to us that, although he does not believe the crisis is over, it poses no threat to Commerzbank (which reportedly owns very few mortgage-backed securities). The securities that it does hold were mostly originated by the bank and not purchased from other institutions. Deutsche Bank's greater exposure results mainly from a difference in investment strategy: Deutsche Bank under Ackermann's leadership has focused on capital markets, while Commerzbank and Dresdner Bank retain a stronger focus on private banking.

¶10. COMMENT. Deutsche Bank, which has enjoyed a reputation for prudence and foresight, is clearly the most exposed of Germany's large co-mercial banks. While its balance sheet remains well in the black, the subprime crunch has left its financial position and Ackermann's image bruised, if not badly damaged. The bank's write-offs may not be so large, but Ackermann's comments have fueled rather than alleviated the crisis of confidence that still has European banks uneasy. Global investors will keep a close eye on the third quarter profit reports of Deutsche Bank and its competitors. END COMMENT.

¶11. This cable has been coordinated with Embassy Berlin.
POWELL